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IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 287

EDWARD McLOUGHLIN,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## Brief of the Attorney General of the State of New York, as *Amicus Curiae*, in Support of the Contention of Petitioner

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

## BRIEF OF THE ATTORNEY GENERAL OF THE STATE OF NEW YORK, AS *AMICUS CURIAE*, IN SUPPORT OF THE CONTENTION OF PETITIONER

### Statement

In view of the importance of the principles involved herein, the Attorney General of the State of New York files this brief as *amicus curiae.*

### Constitutional Question Involved

May the Federal Government impose a tax on the compensation of employees of the State of New York regu-

larly and continuously employed in the Insurance Department of the State of New York in the liquidation of insolvent insurance companies pursuant to the laws of the State?

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The facts upon which the case was decided by the Court below are sufficiently set forth in the brief of the petitioner and need not be repeated here. They may be summarized by saying that the petitioner was an employee of the State of New York engaged in carrying on a governmental function and for which he was paid an annual salary.

It is clear from a careful reading of the opinion of Augustus N. Hand, J., in the Court below, that the order of the Board of Tax Appeals was affirmed upon the ground that the tax "imposes no real burden upon, or impediment to a normal exercise of sovereign power." The opinion sums up the class of cases or situations where exemption from tax has been disallowed. Judge Hand states that there are two such situations:

> "(1) Where a State has departed from its usual governmental functions and engaged in business enterprises for the public benefit, *Helvering* v. *Powers,* 293 U. S. 214; *Ohio* v. *Helvering,* 292 U. S. 360; *South Carolina* v. *United States,* 199 U. S. 437;
>
> (2) Where persons subjected to taxation are neither officers nor regular employees of the State, but are so-called independent contractors, *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514."

With such a statement of the law (and with it we entirely agree), it is difficult to understand the conclusion arrived at by the learned Court below. Clearly, the State

of New York has not "departed from its usual governmental functions" in supervising the great business of insurance for the protection and benefit of its people, and it is impossible to bring the petitioner herein within the second category because, on the conceded facts, the petitioner was a regular employee of the State, paid on an annual basis; he most certainly was not an "independent contractor".

Since, therefore, the petitioner was (1) a regular employee of the State of New York, and (2) engaged in the carrying on of a usual governmental function, the order must be reversed under the authority of *Brush* v. *Commissioner,* 300 U. S. 352, unless the mere fact that the petitioner was paid his salary by the State out of funds which the State itself had secured out of the assets of insurance companies which it was at the time liquidating, requires a different determination. We submit that the source from which the State derives the money from which it pays its employees is wholly irrelevant, whether it be from taxation, assessment, fee, fine, penalty or escheat.

The contention of the Government here and of the Court below that the petitioner was paid from private sources does not wholly accord with the uncontroverted facts of record.

The facts with respect to the payment of petitioner's salary are set forth in the record as follows:

> "8. In the year 1932 the Department of Insurance had a general bank account with the Bank of New York & Trust Company at 48 Wall Street, New York City. *The expenses of the Bureau, including all salaries, were paid by checks drawn on this bank.* This account was referred to as the "Wash Account," as simultaneously with the drawing of checks for salaries, etc., other checks

were drawn on the bank accounts of the companies in liquidation and deposited with the Bank of New York & Trust Company to equalize the amount drawn out therefrom to meet the salaries and other overhead expenses of the Bureau. In drawing checks against the various companies in liquidation to meet (fol. 17) petitioner's compensation and the other expenses of the Bureau, checks would be drawn by an Assistant Special Deputy of Insurance (as representative of the Superintendent of Insurance) on the bank accounts in which the deposits of the various companies were maintained. Each company coming under the jurisdiction of the Bureau kept its separate bank account, and the Superintendent of Insurance (having charge of all the assets of such company) was in a position to draw checks on the account." (Italics ours.)

(Stipulation of Facts—Record, pp. 9-10.)

## POINT I

**Since petitioner was in the employ of the Insurance Department of the State of New York, engaged in carrying on a governmental function of the State, the source of his compensation is immaterial.**

We respectfully submit that there are but two factors which are to be considered in determining whether or not petitioner's salary is exempt from Federal income tax. (1) Was he an employee of the State of New York? The fact that he was such employee was not questioned in the Court below, and could not be under the stipulated facts. (2) Was the petitioner engaged in carrying on a usual governmental function during the tax year in question? The learned Circuit Court of Appeals apparently an-

swered this question in the affirmative saying: "It is unnecessary for us to deal with the question as to whether the taxpayer, when acting as counsel for the liquidating bureau, was engaged by the State in the exercise of essential governmental powers. *It may well be that his activities were essential* • • •" (italics ours). The essential govermental function of the duties and activities of the State Superintendent of Insurance, his deputies and employees, is fully and satisfactorily established by the comprehensive review of the statutes and relevant cases in Point I of petitioner's brief, and need not be enlarged upon here.

The learned Court below, though finding in effect that the petitioner did not come within either of the two "situations" wherein Judge Hand stated that the immunity from taxation did not exist, proceeded to inject *a third factor,* namely, the *source* of the income.

We respectfully submit that there are no authorities lending support to the introduction of this "third factor" where the taxpayer is not subject to the infirmities of "situations" (1) and (2), as defined by Judge Hand. On the contrary, it is the character of the function engaged in which alone determines the application of the principle of governmental immunity in the case of officers and employees. The cases are many in which the taxpayer's compensation was held exempt from Federal tax even though received from sources other than the State itself. That factor does not alter the constitutional principle that governmental activities may not be taxed.

The sovereign must be free not alone to select its agents and employees, but to select its method of compensating them. The *interference* with the state and with its agents constitutes the burden. Hence, to tax a

state employee, because his compensation is paid out of *funds in the charge of the state* rather than from the state treasury, is to deprive the sovereign of this freedom to choose the method of compensation. This interference is the *burden* which this Court has always referred to in these employee cases. This was clear in the argument before this Court in the *Brush* case when the Attorney General argued that the City of New York collected revenues from the sale of water.

In the recent case of *New York ex rel. Rogers* v. *Graves*, 299 U. S. 401, the taxpayer's salary was paid not out of the United States Treasury, but out of the profits of the Panama R. R. Co. In that case, while the primary purpose of the enterprise was legitimately governmental, its incidental use was a business enterprise run for profit, for private purposes. In the instant case, no part or division of the Insurance Department of the State of New York constitutes a business enterprise. This Court held in the *Rogers* case that the salary of the taxpayer (the general counsel of the railroad company) was exempt from taxation.

It is submitted that petitioner as an employee of the State of New York is likewise entitled to immunity from the income tax of the Federal Government. In *The Collector* v. *Day* (1870), 11 Wall. 113, this Court, after referring to the case of *Dobbins* v. *The Commissioners* (1842), 16 Peters 435, stated at page 124:

> "And we shall now proceed to show that, under the same construction of that instrument (the Constitution), and for like reasons, that government is prohibited from taxing the salary of the judicial officer of a State".

The principle established in *The Collector* v. *Day, supra,* that the immunity of a State officer or employee from Federal tax is based on the same grounds as the immunity of a Federal officer from state tax has never been questioned by this Court.

In another case, only recently decided by this Court (*Brush* v. *Commissioner,* 300 U. S. 352), it was held that the salary of the Chief Engineer of the Board of Water Supply, New York City, was immune from Federal income tax. In that case, the *source* of the taxpayer's salary was not deemed to be vital. Yet the learned Court below attempted to distinguish both the *Rogers* case and the *Brush* case from the case at bar, saying:

> "In each instance it could properly be said that, *within the old rule,* there was a burden on the governmental enterprise and not, as here, a taxation of the salary of a state employee engaged in liquidating a private corporation and paid out of its property.". (Italics ours.)

The learned Court did not attempt to refer to any case which abrogated or even changed "the old rule". As far as we are aware, "the old rule", first laid down in *McCulloch* v. *Maryland,* 4 Wheaton 316, has been consistently followed to the present day. Many of the cases following *McCulloch* v. *Maryland* are collated and commented upon in petitioner's brief and no good purpose would be served by repeating them here.

The "burden" test is properly applied, not when the tax is assessed directly against a governmental activity (such as a tax on a state employee's salary), but only to determine whether a tax assessed against an independent contractor or a tax indirectly affecting a state will or will not, in fact, result in interference with governmental ac-

tivity. In the case of an employee, the interference is held to exist as a matter of law.

The learned Court below felt constrained to refuse to follow the Fifth Circuit in the case of *Therrel* v. *Commissioner,* 88 Fed. 2d. 869, where, as here, the taxpayer's compensation was paid by the State from funds it had received not from taxes turned into its general treasury, but from levies upon the assets of insolvent banks.

The learned Court below likewise frowned upon the decision of the Circuit Court of Appeals for the Fifth Circuit in *Hoskins* v. *Commissioner,* 84 Fed. 2d. 627, where again the compensation of the taxpayer was paid not out of the State Treasury nor out of the funds of the school district, but out of the gross income of a cafeteria which he was employed to supervise. In each of the two cases above referred to, the Court proceeded to determine whether or not the business in which the taxpayer was engaged was that of assisting in an essential governmental function, and also if he was an officer or employee of the State or of a political subdivision thereof. Answering those two questions in the affirmative, the Court in those cases quite properly gave no consideration to the *source* of the taxpayer's income.

The Third Circuit refused to follow the decision below and unanimously reversed the B. T. A. upon a set of facts not even as favorable to the petitioner as those in the case at bar (*Freedman* v. *Commissioner* (1937), C. C. A. 3rd, 92 Fed. (2nd) 150).

As was said in a well considered case and which has been quoted with approval on many occasions:

> "• • • That his services are compensated by fees and not by a salary, is of no importance. Many more important officials of the state are paid by fees. It is for the government which appoints

him to determine how he shall be paid, and he is no less a governmental official because paid by fees for services rendered than if paid a stipulated salary out of the treasury of the state.

The test as to whether a notary is engaged in the exercise of the governmental powers of the state does not depend upon how his compensation is provided. That is a matter for legislative regulation, and in no wise affects the nature or powers of the official who is so compensated. In Freedman *v.* Sigel, 10 Blatchf. 327, and Fed. Cas. No. 5,080, a tax upon the salary of a state judge was sought to be sustained upon the ground that his salary was fixed by the supervisors of the county, and paid out of the county treasury, and not by the state. Judge Shipman held that he was, nevertheless, a state official, and his salary exempt from federal taxation, although fixed and paid by a county of the state."

*Bettman* v. *Warwick,* 108 Fed. Rep. 46-48.

The principle at stake in these cases was well expressed by this Court in *Macallen Co.* v. *Massachusetts,* 279 U. S. 620, 628, where Mr. Justice Sutherland said:

> "Not only may the power to tax be exercised oppressively, but for one government—state or national—to lay a tax upon the instrumentalities or securities of the other is derogatory to the latter's dignity, subversive of its powers, and repugnant to its paramount authority."

The State may determine the methods of compensating its officers and employees. If it be argued that a "burden" upon the State must be shown (which we emphatically deny), the interference with the State's absolute right to determine the method is such "burden".

*The State employed McLoughlin. He was engaged in carrying out a usual governmental function. The State*

*paid McLoughlin. How it reimbursed itself for that expense is irrelevant.*

We submit that the order of the Circuit Court of Appeals for the Second Circuit should be reversed and petitioner's compensation received as an employee of the New York State Insurance Department be held exempt from Federal income tax.

## POINT II

**The order of the Circuit Court of Appeals for the Second Circuit should be reversed and petitioner's compensation received as an employee of the New York State Insurance Department be held exempt from Federal income tax.**

Respectfully submitted,

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# TRANSCRIPT OF RECORD

## SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 597

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

CLARENCE M. FREEDMAN

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED NOVEMBER 23, 1937
CERTIORARI GRANTED DECEMBER 6, 1937

# SUPREME COURT OF THE UNITED STATES

## OCTOBER TERM, 1937

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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